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Supreme Court, U.S.
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IN THE

Supreme Court Of The United States

OCTOBER TERM, 1996

ROBERT L. BROWN, et al.,
Petitioners,

vs.

PERRY MENDEL,
Respondent.

On Petition for Writ of Certiorari to the
United States Court of Appeals for the Eleventh Circuit

PETITION FOR WRIT OF CERTIORARI

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November 1996

54 pp

QUESTIONS PRESENTED

Section 20(a) of the Securities Exchange Act of 1934 provides secondary liability for every person who directly or indirectly controls any person liable for a violation of the securities laws. The court below established a two prong test for "controlling person" liability, i.e., that the "controlling person" (i) must be able to control the general affairs (the day-to-day activities) of the primary violator at the time the entity violated the securities laws, and (ii) had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability. The questions presented are:

1. Whether a corporate officer and director who was a controlling person of the primary violator at the time the decisions were made which resulted in the primary violation and who continued to participate in and influence corporate policy through the time of the offering at issue can avoid secondary liability by submitting his formal resignation shortly prior to the time the primary violation was consummated, thus eliminating his ability to control the day-to-day activities of the primary violator.

2. Whether a person who was a culpable participant in the primary violation can escape secondary liability solely because he did not possess the power to control the day-to-day activities of the primary violator at the time the securities law violations were concluded.

PARTIES

The parties to the proceeding in the Court below and the parties to this proceeding are:

1. Robert L. Brown
2. Perry Mendel
3. Members of the class certified by the United States District Court for the Middle District of Alabama including all beneficial owners of the common stock of Kinder-Care, Inc. ("KCI") as of October 9, 1989, who, pursuant to KCI's October 4, 1989 prospectus, were issued rights to purchase shares of the common stock of Kinder-Care Learning Centers, Inc. ("KCLC") to the extent, but only to the extent, that their claims are based on their exercise, in accordance with such prospectus, of the rights they were issued to purchase KCLC common stock from October 9, 1989 to and including October 26, 1989, excluding: (1) all members of the class in *Hynes, et al. v. Perry Mendel, et al.*, Consolidated Civil Action Nos. 90-1204-N and 92-D-573-N, as certified by that certain October 12, 1993 order of the United States District Court for the Middle District of Alabama, Northern Division; (2) those persons whose claims are based upon rights purchased or otherwise acquired through secondary market or private transactions; (3) Perry Mendel, Richard Grassgreen, The Enstar Group, Inc., The Lodestar Group, Inc., their immediate families, their co-conspirators and aiders and abettors, their controlling persons, any person, firm, trust, corporation, officer, director or other individual or entity in which any of them has a controlling interest or which is related to or affiliated with or controlled by any of them; and (4) the legal representatives, heirs, predecessors, successors or assigns of any such excluded party;

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No.____

IN THE

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OCTOBER TERM, 1996

ROBERT L. BROWN, et al.,

Petitioners,

vs.

PERRY MENDEL,

Respondent.

On Petition for Writ of Certiorari to the
United States Court of Appeals for the Eleventh Circuit

PETITION FOR WRIT OF CERTIORARI

Robert L. Brown, and all those similarly situated, respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eleventh Circuit (App., infra, A-1) is reported at 84 F.3d 393. The opinion of the United States District Court

for the Middle District of Alabama (App., infra., B-1) is reported at 864 F.Supp.1138.

JURISDICTION

The United States Court of Appeals for the Eleventh Circuit entered its judgment on May 31, 1996 and denied Petitioners' application for rehearing and suggestion for rehearing en banc on August 26, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTE INVOLVED

The question presented arises under Section 20(a) of the Securities Exchange Act of 1934, which provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. §78t(a)

STATEMENT OF THE CASE

The underlying action was brought by Robert L. Brown, individually and on behalf of all other persons who purchased the common stock of Kinder-Care Learning Centers, Inc. ("KCLC") pursuant to the issuance by Kinder-Care, Inc. ("KCI") of rights to purchase the common stock of KCLC (the "Rights Offering"). Brown alleged that KCI committed fraud in the sale of securities in violation of 15 U.S.C. §78(j) and Rule 10b-5 promul-

gated thereunder, and that Respondent Perry Mendel[1] ("Mendel") was liable for such alleged fraud as a "control person" of KCI pursuant to 15 U.S.C. §78t(a). The district court granted Mendel's motion for summary judgment on the basis that Mendel did not meet the "control person" test it developed. The Eleventh Circuit adopted the test developed by the district court and affirmed the district court's holding.

A. The Organization and Operation of KCI and KCLC.

Mendel founded KCI in 1970. At the time it began operations, KCI was engaged exclusively in the operation of child day-care centers. However, in the years prior to 1987, KCI had greatly expanded its operations to include financial services and retail businesses. Prior to January 1987, the child care operations of KCI were operated as an unincorporated division of KCI. In January 1987, KCLC was incorporated and began operating as a wholly-owned subsidiary of KCI. In August 1988, KCI sold approximately 13% of its shares in KCLC to the public.

From his founding of KCI in 1970 through his retirement in 1990, Mendel served KCI and KCLC in various executive capacities, including Chairman of the Board of each company, President of each company, and Chief Executive Officer of each company. (R-3-81, Ex. 9, p.46). In particular, beginning with the incorporation of KCLC in 1987 and through May 26, 1989, Mendel was simultaneously (i) Chairman of the Board of Directors of KCI, (ii) Chairman of the Board of Directors of KCLC, and (iii) Chairman of KCI's Executive Committee. (R-3-81, Ex. 9, p.46).

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[1]The other named defendants were dismissed from the case as a result of their filing of petitions in bankruptcy.

B. The Rights Offering.

During early 1989, KCI and KCLC began exploring the possibility of restructuring their operations with the stated goal of creating two separate companies that would be owned, operated and managed as unrelated public companies (the "Restructuring"). If such Restructuring were effectuated, it was envisioned that KCI would operate the financial and retail businesses and KCLC would operate the day-care and educational operations.

After months of meetings and the review of the reports and opinions of various investment bankers and other "experts," an initial agreement by and between KCI, KCLC, and other involved parties regarding the Restructuring was executed on May 26, 1989 (the "Initial Restructuring Agreement"). However, prior to the approval of the Initial Restructuring Agreement, Mendel as Chairman of KCI proposed that the Restructuring be made subject to the approval of the KCLC Board, which he also chaired. (R-3-87, Ex. 8, p. 4). Mendel's proposal was adopted and, thus, KCLC was a necessary party to the Initial Restructuring Agreement, and the Rights Offering could not have been effectuated without the approval and consent of KCLC.

The Restructuring was first approved by KCI's executive committee, which was chaired by Mendel, and it was then approved on May 26, 1989, by the Boards of Directors of KCI and KCLC, both of which were chaired by Mendel. On that same day, Mendel formally resigned from his positions with KCI, but remained Chairman of the Board of Directors of KCLC and its Chief Executive Officer.

Thereafter, the KCI board invited Mendel to attend its special meeting during which an amendment, which was necessary for tax purposes, to the Initial Restructuring Agreement was to be considered, and Mendel in fact at-

tended the KCI board meeting. (R-3-87, Ex. 10). Thereafter, KCI's board approved the amendment. However, the amendment to the Restructuring Agreement could not become effective until approved by KCLC's board which Mendel chaired. On September 21, 1989, less than two weeks prior to the Rights Offering and after Mendel had attended KCI's board meeting, KCLC's Board approved, with Mendel's support, the amendment to the Initial Restructuring Agreement. (R-3-87, Ex. 11).

The Prospectus issued in connection with the Rights Offering described the relationship between KCI and KCLC as follows:

> The terms and conditions of the Initial Restructuring Agreement were negotiated at arm's length by KCI and KCLC, on the one hand, and the Lodestar Group, on the other. **KCI and KCLC were commonly controlled when the terms and conditions of the Restructuring Agreement and the Related Agreements were agreed upon and, therefore, such agreements were not the product of arm's length negotiations as between KCI and KCLC,** although the terms and conditions of all of the agreements were approved by a majority of the independent directors of both companies.

(R-3-81, Ex. 9, pp. 1, 30, emphasis added).

On October 5, 1989, Mendel disseminated a letter to all KCLC shareholders describing the Rights Offering, and he enclosed therewith a copy of the Prospectus which he stated had been "*prepared jointly by KCI and the Company (KCLC).*" This letter provided, in pertinent part, as follows:

> To Stockholders of Kinder-Care Learning Centers, Inc.
>
> As you may know, Kinder-Care, Inc. ("KCI") and the Company have agreed to, among other

things, a disposition by KCI of all of its shares of the Company's common stock owned by KCI and the sale of certain shares of the Company's common stock by KCI to members of The Lodestar Group, a New York investment banking firm. **For your information, enclosed is a copy of the Prospectus** *prepared jointly by KCI and the Company* **which also is being distributed to all of the stockholders of KCI.** The Prospectus contains information regarding a restructuring of KCI and the Company, pursuant to which the **rights offering** and sale of the Company's common stock is to be accomplished.

. . .

We believe that the restructuring will prove to be a significant development for the Company, its employees, and for you the owners of the Company.

Sincerely yours,
/s/Perry Mendel
PERRY MENDEL
Chairman of the Board
and Chief Executive Officer

(R-3-87, Ex. 12, emphasis added.)

C. Course of Proceedings Below.

The action was commenced on November 30, 1990. After numerous delays caused by the bankruptcy filings of other named defendants, the district court certified the class as previously described herein. Mendel thereafter moved for summary judgment asserting, among other things, that there was insufficient evidence to create a jury issue as to whether he was a "controlling person" of KCI at relevant times. The district court granted a final summary judgment in favor of Mendel on September 7, 1994, holding that Mendel was not a "controlling person"

as a matter of law. In that regard, the district court formulated its own test for determining "controlling person" liability. The district court held that a person is liable as a controlling person if he or she (i) had the power to control the "general affairs" of such entity primarily liable "at the time" the entity violated the securities laws, and (ii) had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability. Although the district court found sufficient evidence that Mendel met the second prong of the test, the district court determined that there was insufficient evidence of Mendel's "power to control the general affairs" of KCI "at the time" KCI violated the securities laws. On May 31, 1996, the United States Court of Appeals for the Eleventh Circuit affirmed the summary judgment, specifically adopting the "controlling person" test formulated by the district court. The Eleventh Circuit denied Petitioners' application for rehearing on August 26, 1996.

REASONS FOR GRANTING THE WRIT

The courts of appeal are in a state of confusion and conflict over the test to be applied in determining "controlling person" liability under Section 20(a) of the Securities Exchange Act of 1934. 15 U.S.C. §78t(a). This confusion regarding the applicable standard has produced a real conflict among the circuits. Although in many cases the different tests will produce consistent results, this case underscores the need for guidance from this Court. It is clear that Mendel would meet the "controlling person" tests established by several circuits, but he did not meet the test established by the Eleventh Circuit. Such inconsistent and conflicting results could be remedied by guidance from this Court. Further, because "controlling person" liability is now the only basis of secondary liabil-

ity under the federal securities laws[2], it is critically important for this Court to set forth uniform principles to govern the nationwide litigation of such issues. Lastly, the decision below is erroneous.

I. THERE IS A SPLIT OF AUTHORITY IN THE CIRCUIT COURTS REGARDING THE APPROPRIATE TEST FOR CONTROLLING PERSON LIABILITY WHICH CREATES INCONSISTENT RESULTS AS EVIDENCED BY THE ELEVENTH CIRCUIT'S OPINION.

Mendel founded KCI and served as Chairman of the Board of KCI and Chairman of its Executive Committee until his resignation on May 26, 1989. Further, Mendel put in motion the Restructuring and made the Restructuring subject to the approval of KCLC's board, which he also chaired. Mendel essentially conceded in the district court, as he had to, that he was a controlling person of KCI at all relevant times up to May 26, 1989, the day he formally resigned from his various positions with KCI. Mendel contended, however, that he ceased being a controlling person solely because of his formal resignation. The test adopted by the Eleventh Circuit allowed him to escape liability as a controlling person because of his resignation even though he participated in and influenced the corporate policies of KCI through the date of the Rights Offering.

In that regard, the Eleventh Circuit's test differs greatly from the tests adopted in the other circuits. The Eleventh Circuit requires that the plaintiff show that the defendant had the power to *control the general affairs* (i.e.,

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[2]This Court, of course, abolished aider and abettor liability in *Central Bank v. First Interstate Bank*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994). See discussion pp. 11-12, infra.

the day-to-day activities) of the entity primarily liable *at the time* the entity violated the securities laws. Also, a plaintiff must show that the defendant had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability. The district court found that Mendel met the second prong of the test.

The law in the Fifth, Sixth, Seventh, Eighth, and Tenth Circuits requires a plaintiff to establish controlling person liability by showing that (i) the defendant *participated in the general operations* of the entity primarily liable, and (ii) that the defendant *possessed the power to control the specific transaction* or activity upon which the primary violation is based. See *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir.1985), *cert. denied*, 474 U.S. 1057, 106 S.Ct. 798, 88 L.Ed.2d 774 (1986); *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 887, 881 (7th Cir.1992), *cert. denied*, 509 U.S. 904, 113 S.Ct. 2994, 125 L.Ed.2d 688 (1993); *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 619-20 (5th Cir.1993), *cert. denied*, 510 U.S 1177, 114 S.Ct. 1219, 127 L.Ed.2d 565 (1994); *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 486 (6th Cir.1992), *cert. denied*, 506 U.S. 1079, 113 S.Ct. 1046, 122 L.Ed.2d 355 (1993); *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898 (10th Cir.1992), *rev'd on other grounds sub nom. Central Bank v. First Interstate Bank*, 511 U.S.164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994).

The Second, Third, and Fourth Circuits require the plaintiff to show that the defendant (i) had the *authority to influence and direct the activities* of the entity primarily liable, and (ii) was a *culpable participant in the primary violation.* See *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir.1981), *cert. denied*, 455 U.S. 938, 102 S.Ct. 1427, 71 L.Ed.2d 648 (1982); *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir.), *cert. denied*, 444 U.S. 868,

100 S.Ct. 143, 62 L.Ed.2d 93 (1979); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir.1973).

In other words, five circuits require that the defendant actually participate in controlling the general operations of the primary violator; three circuits do not require participation in controlling the general affairs of the primary violator. Likewise, five circuits require that the defendant possess the power to control the transaction, but not necessarily participate in it; three require that the defendant actually be a culpable participant in the primary violation.

These results reflect a confusion and uncertainty that it is important for this Court to resolve. Because the district court found substantial evidence that Mendel met the second prong of its test, the conflict among the circuits as to the second prong was not prejudicial to Petitioners. However, as shown hereafter, the first prong of the Eleventh Circuit's test conflicts with the requirements of the other circuits, and it is clear that a different result would have been reached in the other circuits.

The Eleventh Circuit rejected the first prong of the tests of other circuits which requires a showing of only (i) "participation" in the general operations, or (2) the authority to "influence and direct" the activities of the entity primarily liable. Instead, the Eleventh Circuit required a showing that the defendant had the power to *control the general affairs*, i.e., the day-to-day operations of the entity primarily liable, *at the time* the entity violated the securities laws. The Eleventh Circuit found that Mendel's resignation effectively ended his "control" even though he (i) participated in and influenced the preparation of the Initial Restructuring Agreement, (ii) approved the amendment thereto, and (iii) aided in the dissemination of the allegedly fraudulent prospectus that was "jointly prepared" by KCI and KCLC, all at the time KCI and KCLC were "commonly controlled." Thus, even

though the Petitioners showed that Mendel participated in the affairs of KCI and had the authority to influence and direct KCI's activities through the date of the Rights Offering, consistent with the applicable requirements in all other circuits, the test adopted by the Eleventh Circuit resulted in summary judgment for Mendel because he had previously resigned. Further, the conflict between the circuits is even more apparent in application than it is in theory. In *Sharp*, supra, and *Lanza*, supra, outside firms were held to be controlling persons. Obviously, such defendants did not control the general, day-to-day affairs or influence the general activities of the entities primarily liable.

Moreover, the "at the time" of the violation language of the Eleventh Circuit's test is not as logical as it appears at first blush. This is so because a securities violation does not occur until the *actual* sale occurs. Accordingly, a controlling person could resign on the eve of the fraudulent offer and be immune from liability. Such result is absurd but, as demonstrated by its decision in this case, such is now the law in the Eleventh Circuit.

II. THIS COURT'S DECISION IN CENTRAL BANK V. FIRST INTERSTATE BANK ENHANCES THE IMPORTANCE OF THE QUESTION OF STATUTORY CONSTRUCTION PRESENTED.

The enforcement of the federal securities laws through private rights of action is a vital feature of our jurisprudence. It is even more critical in these times of limited governmental resources. In *Central Bank v. First Interstate Bank*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), this Court eliminated aider and abettor liability under the federal securities laws, and thus overturned case law that had developed and had been recognized for decades in each federal circuit. Because of the nation-

wide recognition of aider and abettor liability prior to *Central Bank*, the requisite test for "controlling person" liability was not as crucial as it now is. This is so because there were two causes of action for secondary liability, i.e., controlling person and aider and abettor. Now there is only one. This Court should make the standards for imposing controlling person liability, the only remaining theory of secondary liability available to a defrauded investor, clear, concise, and uniform.

III. THE DECISION BELOW IS ERRONEOUS.

Mendel's activities in this case constitute sufficient evidence from which a jury could reasonably infer that Mendel was a controlling person under any test. In finding otherwise, the Eleventh Circuit failed to follow well-established precedent of this Court which requires courts reviewing summary judgments to consider all the facts, and to draw all reasonable inferences therefrom, in the light most favorable to the non-moving party. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

Mendel was Chairman of KCI's Board of Directors, KCI's Executive Committee, and KCLC's Board of Directors when the Restructuring was planned and, as the minutes reflect, he actively participated in such meetings. The Eleventh Circuit ruled, however, that Mendel's formal resignation from KCI's board on May 26, 1989 ended his control under the federal statute as a matter of law. Thus, his activities in planning the Restructuring were irrelevant. However, it is important to remember that before Mendel resigned from KCI, he insisted that KCI's board vote to make the Restructuring and related agreements subject to the approval of KCLC's board, of which Mendel, of course, was Chairman. **Certainly, a juror could reasonably conclude that Mendel ensured his**

continued "control" of KCI at least through the culmination of the Rights Offering by making the Restructuring Plan subject to the approval of KCLC's board which he chaired. The Ninth Circuit has, in fact, recognized that the power of approval constitutes direct influence over the "policy and decision making process." *See Kersh v. General Council of the Assemblies of God*, 804 F.2d 546, 549 (9th Cir. 1986). The Eleventh Circuit failed to consider Mendel's right of approval as that fact is not even mentioned in the opinion.

This power to approve or to withhold approval constituted sufficient evidence that Mendel controlled the general affairs of KCI. The Restructuring Plan, which had the separation of KCI and KCLC into two companies as its primary purpose, was the all-consuming event for both companies during the summer of 1989. Through the Rights Offering, KCI was attempting to, and did in fact, raise over $160 million. Thus, the power to approve or disapprove the Restructuring gave Mendel the power to control and influence the most important event in the corporate lives of both KCI and KCLC during the relevant time period.

Perhaps the most compelling evidence that Mendel's resignation from KCI was merely a matter of form and not substance is the statement in the Prospectus that the Restructuring Agreements, including the amendment on September 21, 1989, were executed while KCI and KCLC were *"commonly controlled"* and *"not at arm's length."* Thus, *KCI and KCLC were "commonly controlled" at the time the KCLC shares were sold pursuant to the Rights Offering.* A reasonable juror could certainly infer from this statement that "commonly controlled" meant that both companies were controlled by the same people, including Mendel, the founder, Chief Executive Officer and Chairman of KCI for so long, who was then Chairman of KCLC.

The facts that (i) Mendel attended KCI's board meeting to discuss the amendment to the Restructuring, (ii) KCLC, which Mendel chaired, had to approve and did approve such amendment, (iii) *KCLC and KCI were commonly controlled* throughout the Rights Offering period and (iv) that KCLC stock was the subject of the Rights Offering, constitute sufficient evidence from which a reasonable inference can be drawn that Mendel was in a position to, and did, control or influence KCI's management and decision making process up to and including the October 4, 1989 Rights Offering. The Eleventh Circuit erred in finding otherwise.

Evidence of Mendel's controlling person status is not limited to the planning and approval of the Restructuring Plan, the amendment thereto, and the Rights Offering. Added to all these other facts is the fact that Mendel was Chairman of the Board of KCLC at the time KCLC "jointly prepared" the Rights Offering Prospectus. Indeed, the District Court found that such evidence showed ". . . . that Mendel may have had some power of indirect control or influence over the contents of the Prospectus . . ." (R 3-99, p.16). Further, Mendel disseminated the allegedly fraudulent Prospectus with his letter dated October 5, 1989, which acknowledged that the Prospectus had been "jointly prepared" by KCI and KCLC.

Put simply, Mendel (i) founded KCI, (ii) put in motion the Restructuring Plan, (iii) attended a board meeting of KCI to discuss an amendment to the plan, (iv) was then chairman of KCLC, which was "commonly controlled" with KCI and which "jointly prepared" the Prospectus, (v) as Chairman of the Board of KCLC approved the plan, and (vi) also took part in the dissemination of the allegedly fraudulent Prospectus. Mendel assuredly was not due summary judgment.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, James L. North, a member of the Bar of this Court, hereby certify that on this the 25th day of November, 1996, three copies of the Petition for Writ of Certiorari in the above-entitled case were mailed, first class postage prepaid, to the following:

John M. Bolton III, Esq.
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Counsel for Respondent Perry Mendel

I further certify that all parties required to be served have been served.

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INDEX TO APPENDICES

APPENDIX A

May 31, 1996 Opinion of the United States Court of Appeals for the Eleventh Circuit reported at 84 F.3d 393

APPENDIX B

September 7, 1994 Opinion of the United States District Court for the Middle District of Alabama reported at 864 F.Supp. 1138

APPENDIX C

August 26, 1996 Order of the United States Court of Appeals for the Eleventh Circuit denying Petition for Rehearing and Suggestion for Rehearing En Banc

APPENDIX

Robert L. BROWN, and all those similarly situated, Plaintiff—Appellant,

v.

The ENSTAR GROUP, INC., Richard J. Grassgreen, Perry Mendel, Defendants-Appellees.

No. 94-6908.

United States Court of Appeals, Eleventh Circuit.
May 31, 1996.

Appeal from the United States District Court for the Middle District of Alabama.

Before TJOFLAT, Chief Judge, and CARNES, Circuit Judge.*

TJOFLAT, Chief Judge:

This appeal presents the issue of what must be proven to establish "controlling person" liability under section 20(a) of the Securities Exchange Act of 1934 (the "Act"), ch. 404, 48 Stat. 881, 899, 15 U.S.C. § 78t(a) (1994). We adopt the district court's test, and affirm its grant of summary judgment in favor of appellee.

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*Senior Circuit Judge Frank M. Johnson heard argument in this case but did not participate in this decision. This decision is rendered by quorum. 28 U.S.C. § 46(d).

I.

In the late 1960s, appellee Perry Mendel founded what became Kinder-Care, Inc. ("KCI"), a publicly held corporation. He served as president of the child-care company until 1985, when he became chairman of the board of directors. In 1987, KCI established Kinder-Care Learning Centers, Inc. ("KCLC") as a wholly owned subsidiary and Mendel undertook the responsibilities of chairman of KCLC's board of directors in addition to his responsibilities as chair of KCI's board. Not long after KCLC was formed, the management of KCI began to plan a spin-off of the subsidiary, and in 1988, KCI caused KCLC to conduct a public offering of its common stock, reducing KCI's holdings to 87 percent of KCLC's common stock. On May 29, 1989, KCI announced plans for a corporate restructuring which would completely separate KCLC from KCI.

Part of this restructuring called for separate boards of directors for the two companies; to that end, Mendel resigned as chairman of KCI's board effective May 29, 1989. He remained chairman of KCLC's board, however. The uncontroverted evidence is that Mendel had very little contact with KCI's board after his resignation, and retained only a 2.6 percent interest in KCI. Richard Grassgreen, who had been president of KCI since 1985, became KCI's chairman, and continued to plan for the spin-off of KCLC.

Problems with the proposed restructuring developed, and in September of 1989, KCI's board met to discuss alternative plans. Mendel was invited to and did attend this meeting, but no new plan was adopted. At a subsequent meeting, which Mendel did not attend, KCI's board adopted a new plan, which it announced on September 22, 1989. The new plan called for the issuance to KCI shareholders of rights to purchase KCI's shares of KCLC stock.

In connection with the new restructuring plan, KCI issued a Prospectus to its shareholders on October 4, 1989. The Prospectus was prepared primarily by KCI's attorney. There is no evidence that Mendel personally participated in the preparation of the Prospectus. On October 5, Mendel sent a letter to KCLC's shareholders, advising them of the restructuring and enclosing a copy of the Prospectus for their information. In the letter, Mendel stated that the Prospectus had been "jointly prepared" by KCI and KCLC. Shortly after the restructuring was completed, KCI changed its name to The Enstar Group, Inc. ("Enstar").

Appellants are shareholders of KCI/Enstar who bought KCLC stock from KCI as part of the restructuring.[1] They brought a three count complaint against Enstar, Grassgreen, and Mendel,[2] alleging material omissions and fraud in the dissemination of the Prospectus. Enstar and Grassgreen subsequently filed for bankruptcy, and appellants dismissed all claims against those defendants, proceeding against Mendel alone.

Count one of appellants' complaint alleged that, in failing to disclose material facts in the Prospectus, Mendel violated section 10(b) of the Act, 48 Stat. at 891, 15 U.S.C. § 78j(b) (1994), and rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1995), which together provide an implied private right of action for misrepresentations in the purchase or sale of securities. In addition, appellants alleged that Mendel was secondarily li-

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[1]The district court certified a plaintiff class with respect to appellants' federal securities law claims (count one). The court denied appellants' motion to certify a class with respect to appellants' state law claims (count three).

[2]Appellants original complaint referred to Mendel as the chairman of the board of KCI. The district court allowed them to amend their complaint to remedy this error. We refer to the amended complaint as the "complaint."

able for any violations of the Act by KCI because he was a "controlling person" of KCI within the meaning of section 20(a) of the Act. That count further contended that if Mendel was not liable as a controlling person under section 20(a), then he aided and abetted KCI in connection with the 10b-5 violation. Count two alleged a violation of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1964 (1994); this count was dismissed by the district court and is not at issue here. Count three alleged that Mendel committed fraud in violation of Alabama law. No aider and abettor liability was asserted in this last count.

The district court granted summary judgment to Mendel, holding that "the facts cannot legally support a finding that Mendel was a 'controlling person' of KCI" at the time of the issuance of the Prospectus. *Brown v. Mendel*, 864 F.Supp. 1138, 1140 (M.D.Ala. 1994). The court also found that Mendel was not personally involved in the alleged fraud, that he owed no duty to disclose any information to appellants in the Prospectus, and that therefore he could not be liable for fraud under Alabama law. *Id.* at 1147.

II.

We review the district court's grant of summary judgment *de novo*, applying the same legal standards that bound the district court. *See Reserve, Ltd. v. Town of Longboat Key*, 17 F.3d 1374, 1377 (11th Cir. 1994), *cert. denied*, —U.S.—, 115 S.Ct. 729, 130 L.Ed.2d 633 (1995). In making this determination, we view all evidence in the light most favorable to the non-moving party. *See Sammons v. Taylor*, 967 F.2d 1533, 1638 (11th Cir. 1992). Summary judgment is appropriate in cases in which there is no genuine issue of material fact. Fed.R.Civ.P. 56(c). For the reasons that follow, we affirm the district court's grant of summary judgment in favor of Mendel.

With respect to the first count of their complaint, appellants effectively concede that Mendel is liable for violations of the Act only if he is a "controlling person" within the meaning the Act.[3] Section 20(a) provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . .

15 U.S.C. § 78t(a). The regulations promulgated under the Act define control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person." 17 C.F.R. § 230.405 (1995). The burden is on the plaintiff to show that a defendant is a controlling person. The courts of appeals, however, do not agree on exactly how a plaintiff is to meet this burden.

The Eighth Circuit has developed what has become the most widely used test for determining whether a defendant is liable as a controlling person. That court's two-prong test requires a plaintiff to establish that "the defen-

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[3]Appellants also assert that if Mendel is not liable for the 10b-5 violations as a "controlling person" of KCI, then he is liable as an aider and abettor. It is clear from the record, however, that appellants abandoned all aider and abettor claims well before trial. In their response to Mendel's interrogatories, appellants stated unequivocally "Plaintiff[s] no longer contend[ ] that Mendel is liable as an 'aider and abettor.'" Appellants maintained at oral argument that the aiding and abetting allegation was dropped only with respect to the 10b-5 claim. It was only with respect to the 10b-5 claim, however, that appellants raised aiding and abetting allegations. There was no mention in the complaint of aider or abettor liability with respect to the state law claims. We find that appellants abandoned any claim that defendant Mendel was an aider and abettor.

dant . . . actually participated in (*i.e., exercised* control over) the operations of the corporation in general . . . [and] that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated." *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (internal quotation marks and citation omitted), *cert. denied*, 474 U.S. 1057, 106 S.Ct. 798, 88 L.Ed.2d 774 (1986). *Metge's* test has been cited approvingly by a number of courts of appeals. *See, e.g., Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 887, 881 (7th Cir. 1992), *cert. denied*, 509 U.S. 904, 113 S.Ct. 2994, 125 L.Ed.2d 688 (1993); *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 619-20 (5th Cir. 1993), *cert. denied*, ___ U.S. ___, 114 S.Ct. 1219, 127 L.Ed.2d 565 (1994); *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 486 (6th Cir. 1992); *cert. denied*, 506 U.S. 1079, 113 S.Ct. 1046, 122 L.Ed.2d 355 (1993); *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898 (10th Cir. 1992), *rev'd on other grounds sub nom. Central Bank v. First Interstate Bank*, ___U.S. ___, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994).

As the district court noted, our court has not formulated its own test for controlling person liability, nor have we adopted all or part of the Eighth Circuit's test. Two decisions of the former Fifth Circuit provide us with guidance in formulating a test, however.[4] In 1980, we found that a defendant who did not have the power to control the management of a company or the company itself could not be liable as a controlling person under section 20(a). *Pharo v. Smith*, 621 F.2d 656, 670 (5th Cir. 1980). A year later, we found a defendant liable as a controlling person because the evidence established that he "had the requisite power to directly or indirectly con-

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[4]In *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc), this court adopted as binding precedent all decisions of the former Fifth Circuit handed down prior to October 1, 1981.

trol or influence corporate policy." *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981).

The district court devised a test that is a combination of the requirements outlined in *Pharo* and *Thompson*. We find the reasoning of the district court persuasive, and so adopt the test set forth in its dispositive order.[5] In this circuit, a defendant is liable as a controlling person under section 20(a) if he or she "had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws . . . [and] had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability."[6] *Brown v. Mendel*, 864 F.Supp. 1138, 1145 (M.D.Ala. 1994). Of course, the plaintiff must also establish that the controlled person violated the securities laws.

There is no evidence in the record that Mendel had any power over KCI at the time of the issuance of the Prospectus. Appellants insist that because Mendel was chairman of KCI's board of directors at the time KCI

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[5]We do not find footnote 7 of *Rosen v. Cascade Int'l, Inc.*, 21 F.3d 1520, 1525 n. 7 (11th cir. 1994), to be contrary to our holding in the instant case. The *Rosen* footnote is not only dictum, it is also contrary to *G.A. Thompson & Co.*, 636 F.2d at 958 ("Neither [the regulation] nor the statute appears to require participation in the wrongful transaction."), which is binding authority on this court. *See also Abbott v. Equity Group, Inc.*, 2 F.3d 613, 620 n. 18 (5th Cir. 1993) (noting that *Thompson* rejected a "culpable participation" requirement).

[6]There is an important distinction between the test we adopt today and the Eighth Circuit's test discussed above. The Eighth Circuit's test requires a plaintiff to prove that a defendant actually exercised power over the entity primarily liable. Because we hold *infra* that Mendel neither possessed nor exercised power over KCI at the time the Prospectus was issued, we do not need to decide here whether "power to control the general affairs of the entity primarily liable" means simply abstract power to control or actual exercise of the power to control.

decided to restructure, he was a controlling person of KCI. The only fraud alleged, however, is fraud in the preparation and dissemination of the Prospectus. Appellants allege no violation of the Act in connection with the restructuring itself. Thus, for Mendel to be liable as a controlling person in this case, he must have had the power to control KCI at the time the Prospectus was issued. The district court correctly held that Mendel was not a controlling person of KCI, and thus cannot be secondarily liable for KCI's alleged securities law violations.

We likewise affirm the district court's grant of summary judgment in favor of Mendel on appellants' count three state-law claims. Under Alabama law, fraud is the "[s]uppression of a material fact which the party is under an obligation to communicate." Ala. Code § 6-5-102 (1995). There is no evidence in the record that Mendel was under any obligation to communicate anything to the appellants that would support appellants' state law claims. Appellants were shareholders of KCI, not KCLC. As previously discussed, Mendel had no role in the management of KCI at the time the Prospectus was issued, and thus he did not stand in a fiduciary relationship to KCI's shareholders with respect to the issuance or the contents of the Prospectus.

AFFIRMED.

Robert L. BROWN, suing on behalf of himself and all persons similarly situated, Plaintiffs,

v.

Perry MENDEL, Defendant.

Civ. A. No. 90-A-1268-N.

United States District Court, M.D. Alabama, Northern Division.

Sept. 7, 1994.

MEMORANDUM OPINION

ALBRITTON, District Judge.

I. INTRODUCTION

Plaintiff, Robert Brown ("Brown"), filed this class action on May 12, 1992. This cause is now before the court on the Motion for Summary Judgment filed by Defendant, Perry Mendel ("Mendel") on June 10, 1994.

In October 1989, Kinder-Care, Inc. ("KCI") owned 87% of the common stock of its subsidiary, Kinder-Care Learning Centers, Inc. ("KCLC"). Brown alleges that he and other members of the class, shareholders of KCI, purchased common stock in KCLC pursuant to the October 4, 1989 issuance by KCI to its shareholders of rights to purchase 39,825,960 shares of KCLC (the "Rights Of-

fering") owned by KCI. In connection with the Rights Offering, KCI prepared and disseminated to its shareholders a Prospectus dated October 4, 1989. Brown alleges that this Prospectus omitted material facts in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and SEC Rule 10b-5 promulgated thereunder and that consequently, he and other members of the class were defrauded.

Brown originally sued The Enstar Group Inc., the corporate successor to KCI, and Richard J. Grassgreen in addition to Mendel. Following bankruptcies by Enstar and Grassgreen, Brown dismissed his claims against those defendants and proceeded against Mendel alone. Brown contends that Mendel is secondarily liable under § 20(a) of the Securities Exchange Act of 1934 for the issuance of the Prospectus because he was a "controlling person" of KCI. In addition to these grounds, Brown alleges Mendel committed common law fraud and violated sections of the Alabama Code.[1]

On the other hand, Mendel contends that he was not a "controlling person" for purposes of secondary liability under the Securities Exchange Act. Additionally, he claims that the issuers of the Prospectus did not omit material information in violation of Section 10(b) of the Exchange Act. Finally, he asserts he did not violate Alabama law.

Because the court holds that the facts cannot legally support a finding that Mendel was a "controlling person" of KCI at the time the Prospectus was issued, and because the evidence does not show any personal fraud on Brown by Mendel, the court finds that Mendel's Motion for Summary Judgment is due to be Granted.

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[1]This court has certified Brown's federal securities claims as a class action, but has denied class certification of Brown's common law and state statutory claims.

II. FACTS

The court has carefully considered all affidavits, deposition excerpts, and documents submitted in support of and in opposition to the motion. The submissions establish the following facts:

Mendel founded what eventually became KCI more than twenty years ago. The company initially specialized in operating child-care centers. In addition to being the founder of KCI, Mendel served as KCI's President from 1970 until October 10, 1985, when he became Chairman of the Board. KCI expanded its holdings far beyond child-care. By the end of 1987, KCI provided child day care, educational, specialty retail, insurance, financial and related services through its subsidiaries.

In 1987, KCI established KCLC as a wholly-owned subsidiary which ran the child care services operations. In addition to his positions as Chairman of the Board, Chief Executive Officer and Director of KCI, Mendel undertook the responsibilities of Chairman of KCLC's Board of Directors upon its formation.

Following advice from investment bankers that a separation of the businesses would improve the ability of both corporations to obtain financing, the management of KCI began to plan the spin-off of KCLC into a separate public company as early as 1987. In August 1988, KCI caused KCLC to conduct a public offering of common stock. Consequently, KCI's ownership of KCLC was reduced to 87%. KCI abandoned temporarily its plans for the spin-off. It was not until 1989 that KCI resumed planning for the spin-off of KCLC. The KCI Board of Directors held several meetings in April and May of 1989 to discuss various restructuring proposals. The Board adopted a plan on May 26, 1989. On May 29, 1989, KCI issued a press release announcing a corporate restructuring which would separate KCLC from KCI completely.

This restructuring plan called for the creation of separate boards of directors for KCI and KCLC. KCI would offer its shareholders the right to purchase 28 million newly issued shares of KCI common stock. The Lodestar Group ("Lodestar"), an investment bank, would purchase any of these shares which were not purchased in the rights offering. Lodestar would also purchase shares of KCLC. In the next phase of the restructuring plan, KCI would distribute shares of KCLC to existing KCI stockholders in the form of a tax-free dividend.

Effective May 29, 1989, Mendel resigned from the Board of KCI and focused on his duties as Chief Executive Officer of KCLC. Richard Grassgreen, who had served as a director since 1970 and as president since 1985, took over as KCI's Chairman of the Board. Additionally, other officers and directors were shuffled to effectuate a complete separation of the management of KCI and KCLC. For example, Eddie O. Nabors ("Nabors"), once executive vice-president and chief financial officer of both KCI and KCLC, became executive vice-president, chief financial officer and treasurer of KCLC only effective May 26, 1989. The undisputed affidavits of both Mendel and Nabors indicate that Mendel did not have close ties to anyone on the new KCI Board of Directors. After May 1989, KCI and KCLC were entirely separately run companies. Mendel was no longer an officer or director of KCI and owned only 2.6% of its stock.

In September 1989, KCI realized that the Internal Revenue Service would not give the restructuring plan a favorable ruling. KCI needed a new plan. The KCI board met on September 14, 1989 to discuss the problem, and Mendel attended this meeting by invitation as KCLC's Chairman. No new plan was adopted at this meeting. After this meeting, KCI decided to develop a new plan. KCI and KCLC each retained its own analysts for the purpose of obtaining a fairness opinion on the amended

restructuring plan. At a subsequent meeting of the KCI Board of Directors to which Mendel was not invited and which he did not attend, the KCI Board of Directors approved an amended restructuring plan. Although Mendel and the rest of the KCLC Board of Directors approved this plan when it was presented to them by KCI, there is no evidence that Mendel participated in the development of this new plan. KCI announced publicly the amended restructuring plan on September 22, 1989.

By the terms of this new plan, KCI would offer 39,825,960 shares of KCLC stock to shareholders of KCI. For each share of KCI stock a shareholder owned, KCI would issue .7235 rights. Each whole right would entitle the holder to buy one share of KCLC stock at $4.75 per share. Lodestar agreed to buy the rest of KCI's shares of KCLC and to purchase any shares of KCLC not purchased in the Rights Offering.

On October 4, 1989, KCI issued a Prospectus to its shareholders regarding the amended restructuring plan. This Prospectus was prepared by KCI attorney Andrews. In Mendel's deposition, he testified that Andrews was around KCLC quite often working on the Prospectus. Mendel testified that it was his belief that Nabors, KCLC's chief financial officer, was one of the KCLC employees involved in the creation of the Prospectus. Mendel testified that he was not personally involved in the preparation of the Prospectus, and Brown has offered no evidence to refute this.

On October 5, 1989, Mendel sent an informational letter to KCLC shareholders advising them of the Rights Offering being made to shareholders of KCI. Mendel enclosed a copy of the Prospectus with this letter and advised that KCLC was not asking its shareholders to do anything. According to the Mendel letter, KCI and KCLC prepared jointly the Prospectus containing information about the Rights Offering. On October 10, Grassgreen

wrote KCI shareholders and informed them of their rights to purchase KCLC stock.

A short time after the restructuring was completed, KCI changed its name to The Enstar Group, Inc.

Brown and other KCI shareholders purchased KCLC shares pursuant to this Rights Offering and claim that numerous material facts were omitted from the Prospectus in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission, 17 CFR § 240.10b-5. Plaintiffs allege omissions including the following information: the threat of write-downs and losses KCLC faced from its investments in junk bonds; the relationship between KCLC, KCI and Drexel Burnham Lambert ("Drexel"); the criminal activities of Drexel and its employee Michael Milken and the effect those activities would have both on the junk bond market and on the ability of KCI or KCLC to raise capital; and self-dealing by Mendel and Grassgreen. Plaintiff Brown's state law claims also arise out of the omissions.

III. SUMMARY JUDGMENT STANDARD

Rule 56(c) of the Federal Rules of Civil Procedure provides that summary judgment is appropriate where "there is no genuine issue as to any material fact and . . . the moving party is entitled to judgment as a matter of law." Fed.R.Civ.P. 56(c). This standard can be met by the movant, in a case in which the ultimate burden of persuasion at trial rests on the nonmovant, either by submitting affirmative evidence negating an essential element of the nonmovant's claim, or by demonstrating that the nonmovant's evidence itself is insufficient to establish an essential element of his or her claim. *Celotex Corp. v. Catrett,* 477 U.S. 317, 322, 106 S.Ct. 2548, 2552, 91

L.Ed.2d 265 (1986). The burden then shifts to the nonmovant to make a showing sufficient to establish the existence of an essential element to his claims, and on which he bears the burden of proof at trial. *Id.* To satisfy this burden, the nonmovant cannot rest on the pleadings, but must by affidavit or other appropriate means, set forth specific facts showing that there is a genuine issue for trial. Fed.R.Civ.P. 56(e). The court's function in deciding a motion for summary judgment is to determine whether there exist genuine, material issues of fact to be tried, and if not, whether the movant is entitled to a judgment as a matter of law. It is the substantive law that identifies those facts which are material on motions for summary judgment. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248. 106 S.Ct. 2505, 2510, 91 L.Ed.2d 202 (1986). *See also DeLong Equip. Co. v. Washington Mills Abrasive Co.*, 887 F.2d 1499, 1505 (11th Cir. 1989).

When the court considers a motion for summary judgment it must refrain from deciding any material factual issues. All the evidence and the inferences from the underlying facts must be viewed in the light most favorable to the nonmovant. *Earley v. Champion Int'l Corp.*, 907 F.2d 1077, 1080 (11th Cir. 1990). *See also Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587, 106 S.Ct. 1348, 1356, 89 L.Ed.2d 538 (1986). The movant bears "the exacting burden of demonstrating that there is no dispute as to any material fact in the case." *Warrior Tombigbee Transp. Co. v. M/V Nan Fung*, 695 F.2d 1294, 1296 (11th Cir. 1983). *See also Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 157, 90 S.Ct. 1598, 1608, 26 L.Ed.2d 142 (1970).

With these rules and principles of law in mind, the court will determine whether summary judgment is appropriate or whether there exist genuine issues of material fact that should properly proceed to trial for resolution.

IV. DISCUSSION

A. Liability of Mendel Under the Federal Securities Exchange Act

Plaintiffs claim the Prospectus issued by KCI violated 15 U.S.C. § 78(b) and Rule 10b-5. Plaintiffs have not come forward with any evidence that Mendel was personally involved in drafting the allegedly fraudulent prospectus, but they contend that Mendel is liable for this violation by KCI because he was a "controlling person" of KCI under § 20(a) of the Securities Exchange Act. Defendant Mendel moves for summary judgment on the ground that as a matter of law he was not a "controlling person" of KCI at the time KCI issued the Prospectus. Defendant also claims that even if he were secondarily liable as a "controlling person" this motion should be granted because KCI did not violate the securities laws when it issued the Prospectus.

Section 20(a) of the 1934 Securities Exchange Act describes "controlling person" liability as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person whom such controlled person is liable unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a). Due to the remedial nature of this statute, it should be liberally construed. *Myzel v. Fields,* 386 F.2d 718, 738 (8th Cir. 1967). Brown's claim is that KCI (Enstar) was liable to him for securities fraud and that Mendel is secondarily liable for KCI's acts because he was a controlling person of KCI.

The Courts of Appeals have developed different standards to determine whether a defendant qualifies as a "controlling person." Some require a plaintiff to establish that the defendant had "actual authority to influence and direct the activities of the primary wrongdoer" and that the defendant was a "culpable participant" in the primary violation of the securities laws in order to establish § 20(a) liability. *See e.g. Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973).[2] Other courts, including the Eighth Circuit, employ a different two-prong test to determine a defendant's liability under § 20(a):

> plaintiffs must establish, first, that the defendant . . . actually participated in (i.e., exercised control over) the operations of the corporation in general; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this latter power was exercised.

Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985). *Accord, Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992).

Mendel contends that the plaintiff must meet the two-prong *Metge* test to establish controlling person liability, i.e., he must prove that in October 1989 Mendel actually participated in the operations of KCI in general, and that he also had the power to control the contents of the Prospectus. Brown contends that the first prong is not required in this circuit; that he does not have to come forward with any evidence of participation in the general operations of KCI, but only must produce evidence that

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[2]The court does not find footnote 7 to the Eleventh Circuit's Opinion in *Rosen v. Cascade Int'l, Inc.*, 21 F.3d 1520, 1524-25 n. 7 (11th Cir. 1994), to establish this requirement in this circuit.

Mendel had the power to control the contents of the Prospectus.

The Eleventh Circuit has settled some questions about § 20(a) liability. It adopted the definition of control offered by the Securities Exchange Commission. *Pharo v. Smith,* 621 F.2d 656, 670 (5th Cir. 1980)[3]. Therefore, in this context, control means

> the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

Id. Furthermore, the plaintiff bears the burden of establishing that the defendant is a "controlling person" for the purposes of secondary liability under § 20(a). *See G.A. Thompson & Co. v. Partridge,* 636 F.2d 945, 958 (5th Cir. 1981); *Binder v. Gordian Securities, Inc.,* 742 F.Supp. 663, 667 (N.D.Ga. 1990).

A defendant's liability as a "controlling person" depends on whether the defendant "had the requisite power to directly or indirectly control or influence corporate policy." *G.A. Thompson* at 958; *Binder* at 668. A defendant need not have exercised this power; possession of the power is enough to support a finding that the defendant was a "controlling person". *Binder* at 668. Thus, *G.A. Thompson* and *Binder* clearly provide that whether or not the defendant participated in the illegal activity is part of the defendant's affirmative defense not the plaintiff's prima facie case. *G.A. Thompson* at 958; *Binder* at 668. But as *G.A. Thompson* noted, at that time the existing precedent in this circuit was "ambiguous" on

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[3]Decisions of the Fifth Circuit prior to October 1, 1981 are binding in the Eleventh Circuit. *Bonner v. City of Prichard, Ala.,* 661 F.2d 1206, 1210 (11th Cir.1981).

the issue of whether a defendant must have "effective day-to-day control" of the company which is the primary violator to be liable as a "controlling person". *G.A. Thompson* at 958 n. 24. Neither the *G.A. Thompson* court nor *Binder* court needed to decide whether effective day-to-day control of the company generally was a requisite to "controlling person" liability. In those cases, it was clear that the alleged "controlling person" had effective day-to-day control of the company which had violated the securities laws. In *G.A. Thompson,* the defendant was an officer, director and 24% shareholder of the company. *G.A. Thompson* at 949. He was also apparently involved in the day-to-day administration of the company. *Id.* at 958. These factors satisfied the court that the evidence established this defendant was a "controlling person". *Id.* Similarly, the *Binder* court found the "controlling person" standard met by a defendant who was vice-president of the offending company, president and 33% shareholder of a sister company, and "fully capable of apprising himself of any of [the company's] business dealings, including the [offending] transactions." *Binder v. Gordian Securities Inc.,* 742 F.Supp. 663, 668 (N.D.Ga. 1990).

The Eleventh Circuit has not itself addressed the question of whether proof of general control of the primary violator is necessary to establish controlling person liability. The Fifth Circuit has. And, while it is not binding authority, the Fifth Circuit's post 1981 interpretation of its binding decision in *G.A. Thompson* and its requirements for "controlling person" liability is persuasive.

In *Abbott v. Equity Group, Inc.,* 2 F.3d 613 (5th Cir.1993), the Fifth Circuit decided that in addition to requiring a plaintiff to show that the defendant had the requisite control over the specific corporate policy which had resulted in the primary liability a plaintiff also had to show general control over the entity primarily liable. *Id.* at 620. Investors in a Louisiana partnership sued the part-

nership for misrepresentations and omissions in a Private Placement Memorandum which allegedly violated federal securities laws. *Id.* at 618. Investors also sued the surety and the bonding agent as secondarily-liable "controlling persons". *Id.* The Fifth Circuit rejected "controlling person" liability for the surety and the bonding agent and affirmed summary judgment in their favor. *Id.* at 621. This decision was premised on the fact that these defendants had no involvement with nor control over the general operations of the company primarily liable for the securities violation. *Id.* at 620. The plaintiffs failed to make the required "separate showing of control over the controlled entity" because the evidence did not show that the surety and the bonding agent had "power to control the general affairs of [the company primarily liable for the violation]." *Id.* Plaintiffs evidence that these defendants had control or influence over the specific transaction was all insufficient basis for "controlling person" liability. *Id.* at 620-621.

The *Abbott* court did not specifically adopt the first prong of the *Metge* test, but cited its earlier opinion in *Dennis v. General Imaging, Inc.*, 918 F.2d 496 (5th Cir. 1990) as interpreting *G.A. Thompson* to require a plaintiff, for a prima facie case, to show "actual power or influence over the controlled person." *Id.* at 620. The court went on to say:

> *Dennis* is consistent with *Metge* to the extent that both require a separate showing of control over the controlled entity (Equity); but appellants insist that our circuit only requires that they show Home and Graham's power to control Equity, not the actual exercise of that power. We need not presently analyze the above distinction because, even assuming that only the former applies, a reasonable jury could not so find based on the record before us. *Id.* at 620.

Thus, the Fifth Circuit requires proof of at least the *power* to control the general operations of the controlled entity, even if possibly not the *exercise* of that power.

In light of these holdings and in the absence of any authority to the contrary, this court finds that these things must be proved in order to establish that the defendant was a "controlling person" for purposes of § 20(a): First, a plaintiff must show that the defendant had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws. Second, a plaintiff must show that the defendant had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability. Finally, plaintiff must be able to establish the fact that the controlled entity violated the securities laws. If a plaintiff can show that the defendant meets these requirements, the defendant will be held liable as a "controlling person" unless he can show either lack of participation or good faith which are the affirmative defenses.

In his complaint, Brown alleged that Mendel was a "controlling person" of KCI in October 1989, when the Prospectus was issued, because of his position as Chairman of the Board of Enstar (KCI), his ability to control or direct the affairs of Enstar and its affiliates, his stock ownership in Enstar, his close ties with Defendant Grassgreen and his on-going access to material inside information about Enstar, and his activities. Brown now concedes that Mendel was no longer an officer, director, or employee of KCI, much less Chairman of the Board, in October, but contends that several other factors still establish Mendel's control over the policies of KCI. First, plaintiffs point to the long history of Mendel's involvement with KCI. Specifically, plaintiffs argue that Mendel, the long-time head of KCI, master-minded the restructuring of KCI and should not be allowed to escape liability

for his plans because he resigned from his positions of power with KCI before KCI issued the Prospectus. But, plaintiffs do not base their claim on any alleged fraud in the restructuring, only on alleged fraud relating to the Prospectus. Second, plaintiffs contend that Mendel continued to enjoy control and influence over KCI after his resignation on May 26, 1989. Plaintiffs pin this argument on three facts: Mendel's position as head of KCLC which had to approve the amended restructuring, Mendel's presence at the September 14, 1989 meeting of the Board of Directors of KCI where the need for an amended restructuring plan was discussed, and the fact that a letter from Mendel to KCLC shareholders included a copy of the Prospectus and referred to the Prospectus as having been jointly prepared by KCI and KCLC.

The issue for this court is whether a reasonable jury could find that any or all of these facts are enough to establish that Mendel was a "controlling person" of KCI at the time KCI issued the Prospectus which allegedly violates federal securities laws. In other words, would these facts allow a reasonable jury to conclude that Mendel could influence generally the corporate policies of KCI at the time it issued the Prospectus and that Mendel had the requisite power to directly or indirectly control or influence the issuing of the Prospectus itself.

It appears from the facts that Mendel may have had some power of indirect control or influence over the contents of the Prospectus, although there is no evidence that he exercised it, but this alone does not make him a "controlling person" of KCI. Mendel's October 5, 1989 letter to KCLC stockholders does refer to the fact that KCI and KCLC jointly prepared the Prospectus. The evidence also indicates that KCLC employees like Nabors helped draft the Prospectus. As Chief Executive Officer and Chairman of the Board of KCLC, Mendel was in a

position to control KCLC and its employees to some extent. This might allow a reasonable jury to conclude that Mendel had "control" as it has been defined in G.A. *Thompson* over the Prospectus.

However, the facts do not establish a genuine issue of material fact about Mendel's liability as a "controlling person" because he lacked the requisite control over the general affairs of KCI when it issued the Prospectus. At the time KCI issued the Prospectus, Mendel was neither a director, an officer, nor an employee of KCI. He had surrendered his power months before. Mendel offered uncontested proof that he did not have close ties to the new KCI Board of Directors. The history of the restructuring plan provides no evidence that Mendel had the requisite control over KCI. Mendel may have planned a restructuring of the companies before the end of his tenure as head of KCI, but it was a far different restructuring than the plan eventually enacted by KCI after his departure. The restructuring Mendel had envisioned would have distributed KCLC stock to KCI shareholders in the form of a tax-free dividend after a sale of new KCI stock; the amended restructuring plan offered KCI shareholders a chance to purchase KCLC stock. Furthermore, after Mendel's resignation he was only allowed to attend one meeting of the KCI Board of Directors, and this was not the meeting at which the KCI Board of Directors voted on the amended restructuring plan. Mendel owned only 2.6% of the KCI stock which was not enough to give him any general authority over KCI's operations. Plaintiffs submitted no evidence to support the allegation that Mendel had close ties to Grassgreen and access to material inside information about Enstar (KCI) in October. To the contrary, the evidence before the court shows that these ties were no longer close and that Mendel was involved with the child care business of KCLC and no longer with the unrelated businesses of KCI. Plaintiffs

have simply submitted no evidence which could be construed as establishing power of Mendel in October 1989 to control the general affairs of KCI. Thus, the only reasonable conclusion based on the facts before the court is that Mendel lacked influence or control over the day-to-day operations of KCI after his resignation as an officer and director of that corporation in May 1989. Therefore, plaintiffs cannot establish the first requirement for controlling person liability.

Because this court finds that the evidence viewed in the light most favorable to the plaintiff fails to establish a question of fact as to Mendel's liability as a "controlling person" of KCI, summary judgment is due to be granted for Mendel on the federal securities law claims of Count One. This court finds it unnecessary to, and therefore does not, decide if the Prospectus violated the federal securities laws.

B. State Law Fraud Claims

Brown alleges the Prospectus omits material facts. This he contends amounts to common law fraud and violates two sections of the Code of Alabama. Mendel denies that he committed any fraud on Brown. He also contends that the facts omitted were not material and that Brown's reliance upon the Prospectus was not reasonable.

Count Three of Brown's complaint alleges Mendel violated Section 6-5-102 of Code of Alabama which defines a form of fraud. Under this code provision, "[s]uppression of a material fact which the party is under an obligation to communicate constitutes fraud. The obligation to communicate may arise from the confidential relations of the parties or from the particular circumstances of the case." Ala.Code § 6-5-102 (1993). This section of the Code of Alabama is "a codification of the common law." *Jim Short Ford Sales. Inc. v. Washington,* 384 So.2d 83, 86;

(Ala. 1980). The requisite elements of fraud by suppression include: "1) the suppression of a material fact 2) that the defendant was under a duty to communicate 3) either because of a confidential relation between the plaintiff and the defendant or because of the particular circumstances of the case." *Crowder v. Memory Hill Gardens, Inc.*, 516 So.2d 602, 604 (Ala. 1987).

Brown also bases Count Three on Section 6-5-104 of the Code of Alabama which defines fraudulent deceit. It states that "[o]ne who willfully deceives another with intent to induce him to alter his position to his injury or risk is liable for any damage which he thereby suffers." Ala.Code § 6-5-104(a). One of the meanings of the word "deceit" for purposes of this statutory provision is "[t]he suppression of a fact by one who is bound to disclose it or who gives information of other facts which are likely to mislead for want of communication of that fact.' Ala. Code § 6-5-104(b)(3) (1993).

This claim, which is personal to Brown and which has not been certified for class treatment, is not based on a "controlling person" theory; it alleges that Mendel personally committed fraud on Brown on the basis of fraudulent omissions from the Prospectus. Brown offers no evidence of any fact which would establish that Mendel was personally involved in deciding on the contents of the Prospectus or that he had a duty to communicate anything to Brown at the time the Prospectus was issued. As previously discussed, Mendel was no longer in a position of control of KCI when it issued the Prospectus. KCI may have been under a duty to communicate material facts to Brown about the stock he was offered, but Mendel did not share that duty. There is no evidence nor any allegation that Mendel ever communicated with Brown. In light of these facts, no reasonable jury could find that Mendel is liable for fraud under the laws of

Alabama. Summary judgment on Count Three is due to be Granted.

V. CONCLUSION

The plaintiffs in this case were shareholders of KCI (later Enstar) who purchased shares of common stock of KCI's subsidiary, KCLC. The stock was purchased for $4.75 per share pursuant to a Rights Offering issued by KCI to its shareholders in October 1989. Plaintiffs claim that the Prospectus issued by KCI with the rights offering fraudulently omitted material information which, if included, would have caused them not to buy the stock. They further claim that the stock was actually worth far less than they paid for it.

In this action, plaintiffs first sued the corporation that issued the allegedly fraudulent Prospectus, KCI (Enstar) and its President and CEO Richard J. Grassgreen, along with Mendel. Plaintiffs dismissed their claims against Enstar and Grassgreen because those defendants went into bankruptcy. Their claim against Mendel alleged that he was Chairman of the Board of KCI at the time the Prospectus was issued, but they now concede that this was incorrect. Plaintiffs now argue, not that Mendel personally committed any fraud upon them, but that he can be held liable for the fraudulent acts of KCI because when the Prospectus was issued, he was a "controlling person" of KCI. The evidence before the court establishes, however, that at that time Mendel had completely severed all of his ties with KCI except ownership of 2.6% of its stock. He no longer had the power to control or influence the general operations of KCI. Therefore, no matter what wrongdoings Mendel may have committed at other times and to other persons or entities, he was not a "controlling person" of KCI when that corporation allegedly issued a fraudulent Prospectus to its shareholders, and he

cannot be held liable for wrongful acts of that corporation or other persons which he did not commit himself.

A separate order will be entered granting summary judgment in favor of the defendant.

ORDER

In accordance with the Memorandum Opinion entered on this day, it is hereby ORDERED that:

(1) Defendant Mendel's motion for summary judgment on Count One, the federal securities law claim, is GRANTED;

(2) Defendant Mendel's motion for summary judgment on Count Three, Brown's state law fraud claim, is GRANTED.

(3) Since Count Two was dismissed by previous order of the court, this disposes of the entire case and final judgment is hereby entered in favor of Defendant Mendel and against the plaintiffs, with costs taxed against the plaintiffs.

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 94-6908

ROBERT L. BROWN, and all
those similarly situated,

Plaintiff-Appellant,

versus

THE ENSTAR GROUP, INC.;
RICHARD J. GRASSGREEN;
PERRY MENDEL,

Defendants-Appellees.

On Appeal from the United States District Court for the
Middle District of Alabama

ON PETITION(S) FOR REHEARING AND
SUGGESTION(S) OF REHEARING EN BANC (Opinion
_____, 11th Cir., 19 ___, ___ F.2d ___).

Before: TJOFLAT, Chief Judge, and CARNES, Circuit Judge.*

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*Senior Circuit Judge Frank M. Johnson heard argument in this case but did not participate in this decision. This decision is rendered by quorum. 28 U.S.C. 46(d).

PER CURIAM:

The Petition(s) for Rehearing are DENIED and no member of this panel nor other Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure: Eleventh Circuit Rule 35-5), the Suggestion(s) of Rehearing En Banc are DENIED.

ENTERED FOR THE COURT:

/s/ Gerald Ford Tjoflat

UNITED STATES CIRCUIT JUDGE

ORD-42
(6/95)